



House Small Business Committee Hearing
June 5, 2007
***“Sarbanes Oxley Section 404: Will the SEC and PCAOB’s New Standards
Lower Compliance Costs for Small Companies”***

Testimony of:
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Chairwoman Velazquez, Ranking Member Chabot and Members of the Committee, my name is Mark Heesen and I am president of the National Venture Capital Association (NVCA) which is based in Arlington, Virginia. The NVCA comprises more than 480 venture capital firms in the United States and advocates for policies and legislation that are favorable to entrepreneurship, capital formation and innovation.

I would like to thank the Committee for the opportunity to contribute to the discussion around Sarbanes Oxley reform measures. This has been an area of expressed concern for NVCA members and their venture backed entrepreneurs for a significant period of time and we are anxious for relief. Venture backed companies are a critical component of US economic growth. In 2006, companies that got their start with venture capital accounted for 10.5 million US jobs and 2.5 trillion dollars in revenues. That equates to 9 percent of the US private sector employment and 17 percent of US GDP. Companies that were once venture backed include Google, Genentech, Starbucks, FedEx, Intel, eBay and Microsoft. These companies were once small and privately held – waiting for the opportunity to go public. Today the next Microsoft is waiting -- but has yet to go public because SOX compliance has been too burdensome – and other alternatives are available.

As you are all aware, our primary concern with the Sarbanes Oxley law is that the cost and effort related to Section 404 has hindered the economic development of promising venture backed companies in the United States. We have both anecdotal and quantitative evidence that many of these companies have been held back from their ultimate goal of an initial public offering due to the high cost of 404 compliance and the lack of support from the accounting profession. In 2006 there were only 57 venture backed IPO’s on US exchanges and 17 IPO’s on foreign exchanges. Twenty three percent of US venture backed IPO’s did not occur here in the US. Prior to SOX it was virtually unheard of for a US venture-backed company to go public anywhere else but a US exchange.

What is more concerning is that we are now seeing companies that have a high enough profit run rate to consider an IPO choosing to be acquired instead. They want to rid themselves of the SOX burden which currently remains for smaller public companies. The result is a long list of companies that should have been stand alone economic contributors being absorbed into larger entities. Rather than an IPO on a US exchange being the ultimate achievement for a venture backed company, it has now become, at best, one of many options to be considered and, at worst, an outcome that is actually avoided. Imagine if Google had been acquired by Microsoft, or Dell acquired by Compaq, or Genentech acquired by J&J. Perhaps the innovation would have survived but the market value, jobs and revenues would have been diluted substantially.

It has been more than two years since the first recognition that the SOX Section 404 is harmful to small companies. We commend the SEC for its recognition of the problems and its effort to enact solutions. Yet, while focusing on a “top-down, risk-based approach” is well intentioned, the question ultimately has to be “will small companies finally see relief?” Based on preliminary reviews of the of the SEC and PCAOB proposals, our answer is “no”. We do not believe the combined guidance put forth goes far enough to effect the necessary changes to relieve the SOX burden for smaller companies.

Although we are still reviewing both sets of documents, it is particularly troubling that the PCAOB in its release (page 5) states that “the Board believes that the changes made to the proposal reflect refinements, rather than significant shifts in approach.” NVCA and its members do not believe that *refinements* will result in a reduction of the overwhelming costs faced by small companies. Refinements will not stop the drain on company resources that is threatening the continued leadership of the US capital markets.

Our concern is centered primarily on the intentions and behavior of the accounting profession. The recent proposals place too much power in the hands of the auditors that, in the face of both economic and liability concerns, are under tremendous pressure to take the most conservative and expensive auditing path. If the SEC wishes to enact reform measures that are meaningful, the Commission must exercise more strongly their jurisdiction over the PCAOB to insure that improvements will be significant enough to be *material* and will be carried out in the spirit in which they were intended.

The venture capital industry believes that three drivers are critical in this regard: First, we are gravely concerned that the accounting profession will not change its high cost practices and the recent guidance provided by both the SEC and the PCAOB regarding materiality is not specific enough to compel them to do so. Second, the oligopoly that exists for 404 audits leaves no choice for small companies in terms of service providers. It does provide any incentive for the Big 4 to lower costs. Lastly, because of these first two concerns, it is imperative that prior to adoption, all proposed measures are fully field tested to confirm that they will indeed reduce costs.

Raising the Materiality Threshold

One area of guidance where we have significant and immediate concern is the determination of what is and what is not “material” to sound financial reporting. The original SOX language set the probability threshold extremely low. Any area in which there was “more than a remote likelihood” for an error to result in a material mistake on the financials was required to be examined, documented, and reported on to the company’s audit committee. This language comprised just about everything. The proposals put forth by both the SEC and PCAOB suggest changing the language to “reasonable possibility”. We feel this general statement does nothing to distinguish itself from the original language, leaves everything open to interpretation, and will do little to reduce costs.

Chairman Cox has stated throughout the reform considerations over the last year that auditors and companies need to be focusing on the few key items that are really important and pose the most risk. Yet, the standard of materiality as revised will allow the accounting profession to continue to sweep in whatever areas they choose. Although in general we support the move to enact "principles based" guidance, we feel there should be an objective threshold if we are going to properly balance risk and cost.

Accounting Profession Reform

Since SOX was enacted in 2002, the relationship between the Big 4 accounting firms and venture backed companies has become increasingly problematic. Many of our small companies have lost the attention of their auditors as these Big 4 firms are favoring larger public companies who offer lucrative 404 auditing engagements. Those who do maintain their Big 4 relationships do so at a 404 cost that averages close to \$1 million annually. As Sarbanes Oxley allows only for accredited accounting firms to complete 404 audits, our companies are held hostage to this oligopoly which is becoming increasingly untenable from both a cost and management standpoint.

We would not have these large concerns if we had any comfort level that the Big 4 accounting firms actually support SOX reform. But their actions in the field and on reform commissions suggest otherwise. In the last two years, the accounting profession led by the Big 4 has resisted SOX reform while reaping the benefits of lucrative 404 audit engagements. Further, they have publicly warned that the supporters of reform “shouldn’t expect a dramatic reduction in costs” with the adoption of proposals. This is not only the publicly stated view of the Big 4 firms but, anecdotally, the specific message delivered to many of our members’ portfolio companies in recent months. As our companies have entered the planning and fee-setting stages for their 2007 audits with the draft SOX reform proposals available, they are already being told that their auditors don’t expect much, if any, savings in audit fees from the proposals as written. The Big 4 firms are advising our companies that they may have some benefits internally but the level of work the firms will have to perform to complete the internal controls attestation will be unchanged.

Just like smaller public companies, our private venture backed companies – the next Microsofts to which I earlier referred -- are also at the mercy of the Big 4. While one would believe that because these companies are private, they can engage a second tier accounting firm, in reality this is not a viable solution. Investment banks that ultimately take these companies public – or sell them to strategic buyers – require a Big 4 audit as a sign of a clean bill of health. Switching from a second tier firm to a Big 4 firm when the company approaches an IPO is impractical, not only because of the cost and time of reauditing the financials – which every new auditing firm requires in this situation – but also because in today's culture doing so wrongly implies to the market that the company must have something to hide. A company can switch to any other service provider as best fits its needs – lawyers, IT providers, banks. But they cannot switch accounting firms if they hope to go public. Our small companies are paying these large bills because there is no competition. We need to create a system where companies have quality choices outside of four large providers.

If the profession has no intention of being part of the cost lowering solution, US companies of all sizes should have the option to seek alternative service providers. The SEC should allow and Congress should publicly support the ability of accredited accounting professionals beyond the Big 4 to perform 404 attestations. By doing so, the SEC will create a healthy, competitive ecosystem where the market will set the right price for services rendered.

The Big 4 have a choice now to truly embrace cost reducing measures. If they continue to choose poorly, small companies should have the choice to find reasonable alternative providers.

Field Testing Prior to Adoption

Despite what we would consider an urgent need for reform, we will ask today that the SEC move forward cautiously when formalizing the proposed guidance. We can attest as builders of new enterprises that while the plans often look solid on paper, implementation is another story. It is worth taking that added time to ensure that reform recommendations are positioned for success.

Blindly adopting recommendations without field testing them first would be akin to purchasing a company without going through due diligence. Field testing ensures that 1) the recommendations will indeed reduce cost 2) all the players including the accounting profession are operating in the spirit of reform and 3) there are no unintended consequences. Understanding how the reform measures work in the real world before officially adopting them will allow the SEC to make adjustments as necessary without having to re-open a new process. Small companies have already had more than their share of unintended consequences as it relates to Sarbanes Oxley. Let's be sure to get it right – and prove that reform works – before declaring victory. We are willing to work with the SEC in this process.

Conclusion

It has been more than two years since the first public recognition that SOX costs were problematic. The worthy recommendations made by the SEC Advisory Committee on Smaller Public Companies after a comprehensive 13 month effort were largely dismissed. Since that time a Chamber of Commerce Committee, the Hal Scott Committee and others have spent time confirming the problem, but solutions have remained elusive.

We are at a critical inflection point and it has taken us a long time to get here. The good work of all involved will be for naught if the accounting profession does not get on board with cost reduction – or if implementation of the proposals fails. There are means by which we can mitigate these serious risks to reform. But the SEC must be deliberate and strong in their resolve. Taking the time to field test and placing the needed pressure on the Big 4 to join the effort is required. We have waited too long for this reform to take place – but we are willing to wait longer to make sure we get it right.

Thank you.